No. 14,732

IN THE

United States Court of Appeals

For the Ninth Circuit

PACIFIC HOMES, INC., a corporation,
Appellant,

vs.

UNITED STATES OF AMERICA,
Appellee.

On Appeal from the Judgment of the United States District Court for the Northern District of California.

BRIEF FOR THE APPELLEE.

H. BRIAN HOLLAND,
Assistant Attorney General.
ELLIS N. SLACK,
C. GUY TADLOCK,
Attorneys, Department of Justice,
Washington 25, D. C.
LLOYD H. BURKE,
United States Attorney.

PERNAU-WALSH PRINTING CO., SAN FRANCISCO, CALIFORNIA

INDEX

Citations

No. 14,732

IN THE

United States Court of Appeals

For the Ninth Circuit

PACIFIC HOMES, INC., a corporation,
Appellant,

vs.

UNITED STATES OF AMERICA,
Appellee.

On Appeal from the Judgment of the United States District Court for the Northern District of California.

BRIEF FOR THE APPELLEE.

OPINION BELOW.

The opinion of the District Court (R. 39-43) is reported at 129 F. Supp. 796.

JURISDICTION.

This is an appeal involving federal income and excess profits taxes for the fiscal years ending May 31, 1945, May 31, 1946, and May 31, 1947. (R. 43-44.) The taxes in dispute, which amounted to $141,041.48, were paid on February 3, 1948. (R. 6-7, 9, 12-13, 15.) Claims for refund were filed on September 8, 1949

(R. 7, 9, 13, 16), and were rejected by notices dated March 21, 1950, May 15, 1950, and February 6, 1951 (R. 7-8, 10-11, 13, 16). Within the time provided in Section 3772 of the Internal Revenue Code of 1939, as amended, and on March 19, 1952, the taxpayer brought an action in the District Court for recovery of the taxes paid. (R. 3-17.) Jurisdiction was conferred on the District Court by 28 U.S.C., Sections 1340 and 1346. The judgment was entered on February 16, 1955. (R. 49-50.) Within sixty days and on March 10, 1955, a notice of appeal was filed. (R. 50-51.) Jurisdiction is conferred on this Court by 28 U.S.C., Section 1291.

QUESTION PRESENTED.

Whether the District Court was correct in holding that the houses involved were held primarily for sale to customers in the ordinary course of taxpayer's trade or business within the meaning of Section 117(a) and (j) of the Internal Revenue Code of 1939, as amended, and, accordingly, that the gain realized on their sale was subject to taxation as ordinary income.

STATUTE INVOLVED.

Internal Revenue Code of 1939:

SEC. 22. GROSS INCOME.

(a) [As amended by Sec. 1, Public Salary Tax Act of 1939, c. 59, 53 Stat. 574] *General Definition.*—"Gross income" includes gains, prof-

its, and income derived from salaries, wages, or compensation for personal service (including personal service as an officer or employee of a State, or any political subdivision thereof, or any agency or instrumentality of any one or more of the foregoing), of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

* * * * * * *

(26 U.S.C. 1952 ed., Sec. 22.)

SEC. 117. CAPITAL GAINS AND LOSSES.

(a) [As amended by Sec. 115(b) of the Revenue Act of 1941, c. 412, 55 Stat. 687, and Sec. 151(a) of the Revenue Act of 1942, c. 619, 56 Stat. 798] *Definitions.*—As used in this chapter—

(1) *Capital Assets.*—The term "capital assets" means property held by the taxpayer (whether or not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, or property, used in the trade or business, of a character which is subject to the allowance for

depreciation provided in section 23(1), or an obligation of the United States or any of its possessions, or of a State or Territory, or any political subdivision thereof, or of the District of Columbia, issued on or after March 1, 1941, on a discount basis and payable without interest at a fixed maturity date not exceeding one year from the date of issue, or real property used in the trade or business of the taxpayer;

* * * * * * *

(j) [as added by Sec. 151(b) of the Revenue Act of 1942, *supra.*] *Gains and Losses from Involuntary Conversion and From the Sale or Exchange of Certain Property Used in the Trade or Business.*—

(1) *Definition of property used in the trade or business.*—For the purposes of this subsection, the term "property used in the trade or business" means property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23(1), held for more than 6 months, and real property used in the trade or business, held for more than 6 months, which is not (A) property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year, or (B) property held by taxpayer primarily for sale to customers in the ordinary course of his trade or business.

* * * * * * *

(26 U.S.C. 1952 ed., Sec. 117.)

STATEMENT.

The facts as found by the District Court (R. 43-48) are summarized as follows:

The taxpayer, a California corporation, was organized on August 9, 1941, for the purpose of engaging in the business of developing real estate subdivisions and renting and selling houses primarily to defense workers. The authorized capital stock consisted of fifty shares, twenty-six being issued to David D. Bohannon and twenty-four to Ross H. Chamberlain. After May 10, 1945, Chamberlain was the sole stockholder. (R. 44.)

The first subdivision developed by the taxpayer was known as the Homewood Tract. Construction of 212 single-family dwellings on this tract was completed on or about September 1, 1942. Thereafter, taxpayer developed two additional subdivisions, completing the construction of 72 single-family dwellings in the Southwood Tract on or about January 1, 1944, and the construction of 63 single dwellings on the Shoreview Tract on or about February 1, 1944. (R. 44-45.)

When construction was completed in the Homewood Tract all 212 houses were rented to defense workers under leases containing options permitting the tenants to purchase the houses within thirty months. This sales device created a ready-made market for the sale of those houses. All of the houses in the Southwood Tract and 56 of the houses in the Shoreview Tract were initially rented without purchase options in the leases. Seven of the houses in the Shoreview Tract were sold immediately after construction. (R. 45.)

The renting of houses in the Homewood Tract with options to buy in the leases was an effective sales device and was a method of doing business followed by Western Homes, Inc., Rollingwood Corporation and Greenwood Corporation, three other organizations not in issue here, which were initially owned and managed by Chamberlain and Bohannon. Such houses were necessarily held for sale to tenants. The granting of such options was voluntary on the part of the taxpayer. (R. 45-46.)

In a resolution adopted on December 9, 1943, the taxpayer ratified past sales of houses and authorized future sales. (R. 45.)

During the period from June, 1944, through April, 1946, 137 tenants in the Homewood Tract purchased houses by exercising their options. Commencing in April, 1945, and continuing through August, 1946, the remaining 69 houses in this tract were sold to persons without options to buy. (R. 46-47.)

In the period from April, 1945, to August, 1946, all 72 houses in the Southwood Tract were sold and from April, 1945, until July, 1946, the remaining 56 houses in the Shoreview Tract were sold. (R. 47.)

Sales of houses in the three tracts in issue were made during each of the tax years in question and all houses were sold by the end of August, 1946. Additionally, the taxpayer acquired houses in three other tracts in its fiscal year ending May 31, 1946, and sold all such houses by the end of its fiscal year May 31, 1947. (R. 47.)

The taxpayer dissolved and went out of business on May 31, 1947. (R. 47.)

Taxpayer's houses sold themselves. Due to the wartime and postwar demands, the houses were sold without engaging in extensive advertising or sales campaigns. As a deliberate sales technique taxpayer did not place "For Sale" signs on the houses. This had a sales motive in that it gave prospective purchasers a sense of the scarcity of available houses and made taxpayer's houses seem more desirable. Salaried tract managers made most of the sales; however, where their sales efforts were insufficient, sales were made by real estate brokers on a commission basis. (R. 47-48.)

SUMMARY OF ARGUMENT.

The District Court determined that the houses in issue were held primarily for sale to customers in the ordinary course of taxpayer's trade or business.

This Court, as well as other Appellate Courts which have passed on the matter, has held that the issue is a factual one and that upon review the lower Court's decision will not be disturbed unless it is "clearly erroneous".

This review necessarily requires an examination of the entire record by the Appellate Court. In making such an examination it will be seen that there was ample evidence before the District Court to justify its ultimate findings, particularly in the light of the de-

cided cases by this Court and other Appellate Courts on the subject.

Taxpayer contends that it was engaged in a rental business and that the sales were made as a part of a plan to liquidate and dissolve the business. The evidence is inconsistent with this contention and shows, among other things, (1) a decision made by the taxpayer prior to the sales, which resulted in the houses being held for sale, (2) a method of doing business which automatically resulted in sales, (3) sales in all three years involved, (4) activity on the part of taxpayer's principal stockholders in similar undertakings which resulted in frequent and numerous sales of houses, (5) an announced intention to sell houses rather than rent them if this would result in a greater profit, (6) sales activity on the part of the employees of the taxpayer as real estate brokers, and (7) a decline in rental income coupled with a sharp rise in sales income.

The District Court exercised its function with care and its findings and judgment are supported fully by the record.

ARGUMENT.

THE DISTRICT COURT PROPERLY FOUND THAT DURING THE TAXABLE YEARS IN ISSUE THE PROPERTIES IN QUESTION WERE HELD BY THE TAXPAYER CORPORATION PRIMARILY FOR SALE TO CUSTOMERS IN THE ORDINARY COURSE OF ITS TRADE OR BUSINESS.

The single issue for determination here is whether the gain realized from the sale of the houses in ques-

tion is to be treated as ordinary income or is to be afforded treatment as a long-term capital gain.

Taxpayer's contention is that it was its intention at the time of construction to hold the houses for rent (Br. 15) and that this intention continued until the decision was made in May of 1945 to liquidate its assets and, therefore, the gain should be offered as capital gain treatment (Br. 19).

The Internal Revenue Code of 1939, Section 117 (a) (1), *supra,* defines "capital assets" as property held by the taxpayer, but excludes from this definition, among other things, "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business." The taxpayer concedes that the houses were used in a "trade or business." (Br. 14.)[1] Accordingly, taxpayer relies upon Section 117 (j), *supra,* which provides that the gain from the sale of property may be considered as a capital gain if the property comes within the definition in subparagraph (1), of—

> real property used in the trade or business, held for more than 6 months, *which is not* * * * *held* * * * *primarily for sale to customers in the ordinary course of his trade or business.* * * * [Emphasis supplied.]

The Commissioner contends and the District Court found as a fact that (R. 48):

---

[1]In fact, the taxpayer concedes that 164 out of the total of 347 houses were held primarily for *sale* to customers in the ordinary course of its trade or business. (Br. 6, 8.)

> The houses * * * in issue were held primarily for sale to customers in the ordinary course of plaintiff's trade or business * * *.

This finding by the District Court is determinative of the issue and will be accepted if supported by the evidence. The question is one of fact and the lower Court's decision may not be set aside unless "clearly erroneous." Thus, in *Stockton Harbor Indus. Co. v. Commissioner,* 216 F. 2d 638, 650, this Court said:

> As stated in the outset, the scope of our review is limited. * * * We cannot substitute our judgment as to facts for that of the Tax Court, and can only upset the findings if there is no substantial evidence to support them. What is and what is not trade or business and when property is or is not held for sale to customers are questions of fact.[2]

See also *Higgins v. Commissioner,* 312 U.S. 212, rehearing denied, 312 U.S. 714; *Galena Oaks Corp. v. Scofield,* 218 F. 2d 217 (C.A. 5th); *Home Co. v. Commissioner,* 212 F. 2d 637 (C.A. 10th); *Williamson v. Commissioner,* 201 F. 2d 564 (C.A. 4th); *Harriss v. Commissioner,* 143 F. 2d 279 (C.A. 2d); *Fackler v. Commissioner,* 133 F. 2d 509 (C.A. 6th).[3]

---

[2]While many of the cases cited arose in the Tax Court, the scope of review here, as provided in Rule 52(a), Federal Rules of Civil Procedure, is the same.

[3]This Court has fixed and upheld the basic proposition in an array of cases. *McGah v. Commissioner,* 210 F. 2d 769; *Jones v. Commissioner,* 209 F. 2d 415; *Rollingwood Corp. v. Commissioner,* 190 F. 2d 263; *Rubino v. Commissioner,* 186 F. 2d 304, certiorari denied, 342 U.S. 814, etc.

No single criterion or fixed formula has been established for the determination of whether property is held primarily for sale to customers in the ordinary course of business and each case must rest upon its own peculiar set of facts. The test usually emphasized is the frequency and continuity of the transactions resulting in the conduct of a trade or business. *Rollingwood Corp. v. Commissioner,* 190 F. 2d 263 (C.A. 9th); *Ehrman v. Commissioner,* 120 F. 2d 607 (C.A. 9th). The Courts have given recognition to certain other guides, but, as this Court said in the *Stockton Harbor Indus. Co. case, supra,* pp. 650-651:

> * * * in the last analysis, each case must be determined upon its own specific facts, and none of these incidences are present in all cases. * * *

As will be demonstrated below, the District Court's findings were not only free from clear error, but were fully warranted by the evidence.

The taxpayer states that it was its original intention to construct rental units and that this intention carried over until May of 1945. (Br. 15, 19.) However, the Court found that after December 9, 1943, "plaintiff's intention was to pursue whichever activity, renting or selling, proved more profitable" (Finding 6, R. 45) and that "The houses * * * here in issue were held primarily for sale to customers in the ordinary course of plaintiff's trade or business from the time when the decision was made, *prior to the sales in question,* to sell all houses as they became vacant including those not then subject to lease-option agreements" (Finding 16, R. 48). [Emphasis supplied.]

These findings, together with the Court's opinion, make it clear that the date from which the houses were held for sale was on or about December 9, 1943. (R. 40-41.)

There is ample support in the record for these and the other findings. The Court had before it the original application of the taxpayer, dated December 31, 1941, to the F.H.A. for authority to develop the Homewood Tract, which stated that the houses were to be built for sale. (R. 25.) It is true that shortly before March 8, 1943, the taxpayer addressed a letter to F.H.A. advising that "Although the original application was for the purpose of sale, we proceeded on the rental option basis * * *." (R. 25-26, 30.) However, this does not change the purpose for which the houses were held, i.e., for sale. The principal purpose of that letter was, however, to advise of a change in the authorized purchase price from $3,675 per house to $4,100 for 24 units and $4,000 for 151 units. (R. 30-31.)[4]

The taxpayer followed an established method of doing business (one followed in similar operations conducted by taxpayer's two stockholders) which called for the rental of all houses in the Homewood Tract with an option to purchase, and resulted automatically in sales when the options were exercised. (Br. 6.) See, also, Finding 7 (R. 46), which has been

---

[4]In *Delsing v. Commissioner,* 186 F. 2d 59 (C.A. 5th), the lower court relied upon the purpose stated in the application to construct the houses in issue. The Fifth Circuit reversed principally upon this ground. In the present case the application was only one item of evidence before the lower court which furnished a basis for its ultimate finding, *infra.*

accepted as to the part pertinent here by the taxpayer (Br. 6).[5] It is submitted that all houses in the Homewood Tract were held for sale inasmuch as they were all initially rented with options to purchase. Light is shed on the taxpayer's intention with respect to all three tracts from Mr. Chamberlain's testimony (R. 130):

> The Homewood Tract was the first tract and therefore could be considered to be the prototype of all of the other tracts.

Further, the taxpayer's accountant, who installed the system of accounts, made periodic checks and prepared the tax returns for the years in issue, stated in answer to a line of questioning upon cross-examination concerning the description of the kind of business entered on taxpayer's returns that the designation "Development of Subdivision, Renting and Selling Homes to Defense Workers" was an accurate description. (R. 102.) The tax returns for the fiscal years ending May 31, 1942, and May 31, 1943, stated that the kind of business was "Construction and Sale of Defense Homes" (R. 104, 106), while those for fiscal years ending May 31, 1944, 1945, 1946, and 1947 stated that the kind of business was "Renting and Selling Homes * * *" (R. 108, 161, 162, 163).

Additionally, and of major importance, is the extract from the minutes of a meeting of the directors on December 9, 1943, which shows (1) that the chair-

---

[5]The taxpayer in its brief has accepted the finding as to 157 units in the Homewood Tract admitting that they were held for sale from the time of completion. (Br. 6.)

man expressed the intention of taxpayer to sell its houses from time to time and advised the board to ratify prior sales and to authorize future sales, and (2) that the board took the recommended action. (R. 45, 154.) The cross-examination of Mr. Chamberlain in this regard is most revealing (R. 145):

> Q. [by the Assistant United States Attorney]. Is it not true, Mr. Chamberlain, that the decision to sell these houses was made as a result of your determination that that would be the way to make the most profit out of these houses?
>
> A. Well, insofar as we weren't making any money out of rent of them at all, I would say that was a fair statement. * * *

We submit that, from all the evidence, the lower Court was correct in its finding that after December 9, 1943, "plaintiff's intention was to pursue whichever activity, renting or selling, proved more profitable" (R. 45) and that this finding established the date from which the property was held for sale.[6] However, taking the taxpayer's view of the record, which it is submitted is not borne out by the facts, it is seemingly

---

[6]This Court said in *Rollingwood Corp. v. Commissioner, supra* (p. 266):

> Suppose the taxpayer in the instant case intended to rent the houses for as long as he was required to do so under existing regulations and then to sell them. Or suppose his intention was to pursue whichever of these activities proved to be the most profitable, that is, if the *rental market* were good he would continue to rent but if the sales *market* were high he would sell. In either of these suppositions we think it is fair to say that one of the essential purposes (in acquiring or holding the houses) is the purpose of sale. Under such circumstances, if the taxpayer does dispose of the houses by sale, is it within the legislative *purpose* to allow him to treat the proceeds of these sales as a capital gain? We think not.

clear that at least after the alleged decision to liquidate was made in May of 1945, the business continued as either a rental or selling operation depending upon which method of doing business was most profitable. (R. 135; Br. 23.)[7]

Courts have sometimes given consideration to the existence or absence of the advertising campaign carried on by the taxpayer. *Rollingwood v. Commissioner, supra; Home Co. v. Commissioner, supra; Lobello v. Dunlap,* 210 F. 2d 465 (C.A. 5th); *Snell v. Commissioner,* 97 F. 2d 891 (C.A. 5th). However, in the *Rollingwood* case, there was no advertising and no "For Sale" signs used, and this Court said (p. 267):

> Petitioners insist that the sales were passive in that there were no "for sale" signs and no sales force. But the number of sales speak for themselves.

The taxpayer accepts the lower Court's finding that "The houses in effect sold themselves," and that "The absence of 'For Sale' signs on the tracts had a sales motive and was a deliberate sales technique * * *." (R. 47-48; Br. 7-8.) See also testimony of Mr. Chamberlain on page 146 of the Record. The frequency of sales indicates clearly that no advertising campaign was necessary or desirable.

---

[7]Mr. Chamberlain testified (R. 135):

> Although we didn't keep any houses vacant. If somebody came along and wanted to rent a vacant house and didn't want to buy it, why, he was privileged to rent it, just so we would have someone in there that would pay the Bank * * *.

There were sales of houses in the tracts in issue in all three years involved. (R. 34.) Such sales were conducted by a ready-made sales force consisting of the tract managers (R. 135), and when sales lagged in a particular tract, the services of established real estate brokers was solicited (R. 79, 136-137). Taxpayer contends that the decision in *Rollingwood Corp. v. Commissioner, supra,* in which the frequency of sales was a factor, requires a decision in its favor. Taxpayer, of course, must exclude from consideration in making this contention the large number of houses sold under purchase options in the tracts in issue. (Br. 6.) In *Rollingwood,* one of the conditions imposed by the Government was that the houses to be constructed had to be rented initially with an option to purchase. (P. 264.) This provision was "an effective sales device" and resulted in many of the sales in the early years. However, in Rollingwood, two-thirds of the sales were made to non-tenants or persons not holding options to purchase (p. 266), and it cannot be said that the decision was based upon the fact that the leases contained options to purchase. As in *Rollingwood,* the number and frequency of sales in the instant case "speak for themselves."

Even though the sale of 157 houses in the Homewood Tract are not in issue, the taxpayer makes the point that 203 of them were still on hand two years after construction. (Br. 26.) A logical answer is that the houses in Homewood were all rented initially with 30-month options to purchase and, therefore, the tenants had two and one-half years within which to

exercise their options. With reference to the houses in the Southwood and Shoreview Tracts, attention is invited to the fact that they were all rented for a 12-month term and could not be sold until at least one year after the leases had expired. (Br. 17.) The first sales in the tracts were made from fourteen to fifteen months after *completion of construction.* (R. 37-38.) In both tracts this would have been in the Spring of 1945. Thus, the houses were sold when, or soon after, the leases expired, or, as Mr. Chamberlain testified (R. 133):

> A lot of those houses became vacant toward—in 1945, in the spring, and the people that rented them or rented them with options to buy, as they became vacant, why, they were sold also.

It seems clear that sales were made as soon as possible under the leasing arrangements.

Further, the lower Court had support for its conclusion from the overall pattern of taxpayer's business as revealed by the record. It was found, and accepted by the taxpayer, that the "plaintiff was pursuing the same method of doing business as Western Homes, Inc., Rollingwood Corporation and Greenwood Corporation." (R. 46.) See also Exhibit 2. (R. 33.) The taxpayer's counsel in his opening statement advised the Court that in addition to the sale of houses in issue the taxpayer sold certain other property which was not held for six months at time of sale. (R. 54.) Certainly these houses were not constructed or purchased as a rental project. At least 40 houses were purchased and sold in another project after the al-

leged decision to liquidate taxpayer's assets because of the conclusion of the war in Europe, an activity which is inconsistent with the argument that the decision in May of 1945 to sell houses was forced upon taxpayer because of adverse economic conditions. (Br. 22-24.) Cf. *McGah v. Commissioner,* 210 F. 2d 769 (C.A. 9th). This Court considered the economic argument in *Palos Verdes Corp. v. United States,* 201 F. 2d 256, 259, and held that while the owner was forced to dispose of property because it "was eating its head off" through the expense of holding it, he nevertheless resorted to a method of disposal which submitted the property "to customers in the ordinary course of trade or business of real estate." See also *Home Co. v. Commissioner, supra.*

Finally, the decline in taxpayer's income from rental operations and the corresponding rise in sales income is convincing evidence of the activity engaged in and proof of the motive for "selling houses". *Winnick v. Commissioner,* 199 F. 2d 374 (C.A. 6th); *Snell v. Commissioner,* 97 F. 2d 891 (C.A. 5th).

Inasmuch as the issue here is a factual one and each case of this type must be decided upon its own peculiar set of facts, it is not believed to be necessary or helpful to consider further the cases cited by the taxpayer. It is sufficient to distinguish the case of *McGah v. Commissioner, supra,* which is relied upon heavily by the taxpayer. In that case, this Court found that the taxpayers, out of a large number of houses used in a rental business, were required to sell a small number of houses (14) in order to reduce their bank

indebtedness. Additional funds were desired from the bank for further construction of rental houses and the sale of some existing houses was required by the bank before it would make additional loans. The sales involved in the *McGah* case were not numerous and extended over only a portion of one year. The taxpayers there continued in the rental business after the year in question.

In contrast, there were over 300 sales extending over three years in the instant cases and activity continued until all houses were sold.

Certainly, the taxpayer here was not forced to sell its houses, as was the case in *McGah*. Indeed, after May, 1945, at least 40 additional houses were purchased and sold in other tracts.

CONCLUSION.

We submit that the District Court's findings are amply supported and that its judgment is correct and should be affirmed.

Respectfully submitted,

H. Brian Holland,
Assistant Attorney General.
Ellis N. Slack,
C. Guy Tadlock,
Attorneys, Department of Justice,
Washington 25, D. C.

Lloyd H. Burke,
United States Attorney.

October, 1955.